STATE OF MICHIGAN

COURT OF APPEALS

SHERMAN PHARMACY, INC.,

Petitioner-Appellee/Cross-Appellant,

v

DEPARTMENT OF SOCIAL SERVICES,

Respondent-Appellant/Cross-Appellee.

UNPUBLISHED
May 16, 1997

No. 188114
Eaton Circuit Court
LC No. 94-000427-AA

Before: MacKenzie, P.J., and Holbrook, Jr., and T.P. Pickard*, JJ.

PER CURIAM.

In 1988, respondent Department of Social Services (DSS) brought an unsuccessful action against petitioner pharmacy to recover alleged overpayments for Medicaid prescriptions. The pharmacy then sought to recover its attorney fees incurred in defending the action. A hearing referee determined that the pharmacy was not entitled to attorney fees. The circuit court reversed and awarded the pharmacy approximately $38,000 in fees. DSS appeals by leave granted. Petitioner cross-appeals, challenging the court's refusal to allow interest on the award. We reverse.

I

Petitioner's application for an award of costs and attorney fees was made pursuant to § 123 of the Administrative Procedures Act, MCL 24.323; MSA 3.560(223), which provides for an award of attorney fees to the prevailing party in a contested case in the event that the presiding officer finds that the position of the agency involved in the proceeding was frivolous. Petitioner contended that DSS's position in the Medicaid reimbursement proceedings was frivolous under subsection 123(1)(b), which defines a frivolous position as one in which "[t]he agency had no reasonable basis to believe that the facts underlying its legal position were in fact true."

II

* Circuit judge, sitting on the Court of Appeals by assignment.

Medicaid pays providers the actual acquisition cost of prescription drugs supplied to Medicaid recipients. In the underlying contested case, DSS claimed that Medicaid had overpaid petitioner pharmacy and sought reimbursement of the alleged overpayment. The claim was made after DSS conducted a three-year audit of the pharmacy's bills to the Medicaid program. The methodology used in the audit was explained by the hearing referee as follows:

> The department determined the overpayment by obtaining a random sample of 50 Medicaid recipients' prescriptions for each of the three years audited, 1983, 1984 and 1985, and the claims were reviewed. The department's review indicated that 120 services in the sample were overpaid resulting in an error rate of 8.4 percent. This error factor was then extrapolated to Sherman's total paid claims for the audit period of $265,301.66 to arrive at the $22,159.91 overpayment. This was later reduced to $21,599.04.

Petitioner argued that DSS's sampling and extrapolation procedures violated the department's own standards, and that a minimum of one hundred prescriptions per year was required to provide a representative and reliable sample. DSS's statistical expert conceded that she would have changed the sample size to eighty per year if she had been given the opportunity, but she opined that the overall sample of 150 met the reliability standards and other indicators set forth in the DSS manual, and for this reason the sample was statistically valid. Petitioner also objected to the audit on the ground that the sample contained a disproportionately high number of direct drug purchases from manufacturers, as opposed to more expensive purchases made from wholesalers, and thus understated the actual overall cost of the prescriptions.

Following an evidentiary hearing, the hearing referee concluded that the overpayment claim was speculative and unenforceable because the sample size used in the DSS audit was too small to provide a statistically valid basis for calculating any over- or underpayments. In this regard, the hearing referee relied heavily upon the views expressed by petitioner's statistical expert, the fact that DSS's own audit manual called for a sample size of eighty, and the admissions of the DSS expert that the smaller sample size was never "validated" with other samples.

The DSS director declined to follow the hearing referee's recommendation for decision, and instead upheld DSS's determination that petitioner had been overpaid by Medicaid. Specifically, the director noted that while the sample size used by DSS was lower than the size called for in its audit manual, the department's expert witness established that the audit was nonetheless statistically valid. The director also found insufficient support for petitioner's claim that the percentage of its direct purchases during the audit period was substantially less than that in the sample. The circuit court reversed the director's decision, holding that there was not competent, material, and substantial evidence on the whole record to support the director's conclusion that the smaller sample size used by DSS was sufficient. DSS did not appeal the circuit court's decision.

Petitioner then sought costs and fees under MCL 24.323(1); MSA 3.560(223)(1). The hearing referee denied the request, in relevant part, because DSS's position in the contested case was not

"frivolous" as defined by the statute. The referee concluded that DSS had a reasonable basis for believing that it could establish the statistical reliability of its audit sample and rebut petitioner's claim that the percentage of its direct purchases were substantially overstated in the sample, notwithstanding the fact that it ultimately failed to do so:

> The department in this case had a reasonable basis for every aspect of its claim. This included the issue of acquisition costs which was supported by the provisions of the Pharmacy Manual, the 'refills' rule and professional fee which was supported by the Pharmacy Manual, and, the sample of 50 recipients per year in the audit was supported by the testimony of an expert statistician. The decision in the case however necessitated a finding on a very difficult question involving the statistical reliability of the audit sample and in view of the failure by the department's attorney to respond to Sherman's position on direct purchases and the statistician's failure to testify to the reliability of the quality criteria in the department's sample design manual, the director's decision was reversed on appeal. Had the department's case been more thoroughly prepared and presented, the decision may have been upheld.

The circuit court reversed this decision, concluding that the referee abused his discretion in ruling that DSS's position was not frivolous. According to the court:

> [Hearing referee] Judge Kane found that the Department had a "reasonable basis for every aspect of its claim." This conclusion is contrary to the findings of this Court as well as the findings of Judge Kane himself.
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> At the time the [DSS] Director made his decision he had the benefit of the ALJ opinion. The Director knew or should have known that the procedure used by the agency violated agency policy. He should also have known that the petitioner's audit and testimony were valid.
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> * * *
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> The Department knew that it used a sample size that was too small and one over-loaded with direct purchases.
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> This is not a case of reasonable minds disagreeing. While an employee of the Department gave an expert opinion supporting the Director's position, the expert admitted that the sample size was not in accordance with its own procedure. The expert attempted to validate the audit procedures by using the sample itself and she admitted that the Department's audit procedures had never been validated.
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> * * *

> [T]he audit procedures were never verified and there was no reasonable basis to conclude that they were reasonable. It is troubling that the ALJ suggested that the failure of the Department to prevail originally may not be due to the evidence or lack of evidence but to the failure of the Department to be prepared. There does not appear to be any justification for such a statement. Since there is no evidence that the criteria was reliable, it cannot be assumed that it was.
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> This Court finds that the agency had no reasonable basis to believe that the facts underlying its legal position were in fact true. Accordingly the Court finds that the position of the agency was "frivolous" as that term is defined in Section 123(1) of the Administrative Procedures Act.

Then court then awarded petitioner its attorney fees incurred in connection with the contested case and the application for fees and costs, but declined to award interest on the fees.

III

MCL 24.325; MSA 3.560(225) provides that the hearing referee's decision with regard to costs and fees may be modified by a reviewing court only if the court finds that the hearing referee abused his or her discretion or the calculation of the award was not based on substantial evidence. To reverse an agency's decision as an abuse of discretion, the reviewing court must find the result "so palpably and grossly violative of fact and logic that it evidences a perversity of will, a defiance of judgment, or an exercise of passion or bias." *In re Kurzyniec Estate*, 207 Mich App 531, 537; 526 NW2d 191 (1994). On appeal, DSS contends that the circuit court misapplied the abuse of discretion standard and instead substituted its own opinion on the issue of frivolousness for that of the referee. We agree.

In reviewing the referee's determination that the contested case was not frivolous because DSS had a reasonable basis for its claim that petitioner had been overpaid by Medicaid, the circuit court did not indicate that the referee's findings were grossly violative of fact or logic. Instead, the circuit court reversed the referee's decision because the referee's view of the merits of DSS's claim was contrary to his previous findings and those of the circuit court. However, the previous determination that DSS's overpayment claim was not meritorious does not necessarily mean that DSS's position was taken without any reasonable basis for belief that the claim had merit, and hence was frivolous. See *McIntosh v Chrysler Corp*, 212 Mich App 461, 470; 538 NW2d 428 (1995). As stated in *Louya v Beaumont Hospital*, 190 Mich App 151, 162; 475 NW2d 434 (1991), "[t]here is a significant difference between bringing a lawsuit with no basis in law or fact at the outset and failing to present sufficient evidence to justify relief at trial."

In this case, DSS had a reasonable basis in fact to believe that petitioner had been overpaid by Medicaid because 120 of the 150 random samples taken over the three-year period indicated an overpayment. Although the sample size for the individual years was smaller than that recommended by the DSS manual, that fact does not compel the conclusion that DSS's position was frivolous. The mere fact that success on the merits is uncertain or questionable "does not necessarily and logically lead to the

conclusion that the claim is 'frivolous.'" *Louya, supra,* p 162. Further, DSS's expert opined that the sample was statistically valid; petitioner has cited no authority for the proposition that DSS was not entitled to rely on that opinion in pursuing its claim.

Similarly, the fact that the parties came to different conclusions with regard to the number of prescriptions petitioner purchased directly from the manufacturer, at a lower cost, does not support reversal of the hearing referee's decision. Both parties' calculations were the result of statistical projections drawn from a small portion of the actual data. Under the circumstances of this case, therefore, it may not be said that the referee's decision was "palpably and grossly violative of fact and logic," *Kurzyniec Estate, supra,* p 537. The circuit court erred when it reversed the hearing referee's decision. The referee's determination that DSS's position was not frivolous because it had a reasonable basis in fact was not an abuse of discretion.

Our disposition of the above issue makes it unnecessary to address petitioner's cross-appeal.

Reversed.

/s/ Barbara B. MacKenzie
/s/ Donald E. Holbrook, Jr.
/s/ Timothy P. Pickard